# Proposal: Reducing the assessment ratio from 25% to 20% for the commercial and industrial primary property taxes

**PROPOSAL**

This proposal calls for a reduction of the assessment ratio for class 1 properties from its current level of 25% to 20% for primary property taxes. The proposal also provides for the assessment ratio percentages to be reduced over a five to seven year period.

Arizona's current classifications for property tax purposes are as follows (assessment ratios are in parentheses):

**Class 1:** (25%) Mines and mining claim property and standing timber. Local telecommunications service, gas, water, and electric utility company property, pipeline company property, producing oil, and gas property. Commercial and industrial real property not included in other classes. *(A.R.S. § 42-12001)*

**Class 2 (Real):** (16%) Agricultural real property, vacant land, and non-profit property. *(A.R.S. § 42-12002)*

**Class 2 (Personal):** (16%) Agricultural and non-profit personal property.

**Class 3:** (10%) Owner-occupied residential property. *(A.R.S. § 42-12003)*

**Class 4**: (10%) Leased or rented residential, childcare facilities, nonprofit residential housing facilities, licensed residential/nursing care institutions, transient lodging, employee's living quarters, and residential common areas. *(A.R.S. § 42-12004)*

**Class 5:** (20%) Railroads, private car companies, and flight property. *(A.R.S. § 42-12005)*

**Class 6**: (5%) Noncommercial historic property, foreign trade zone property, military reuse zone property, enterprise zone property, environmental technology property, and environmental remediation property. *(A.R.S. § 42-12006)*

**Class 7 (Base):** (25%) Historic base value for property included in Class 1. *(A.R.S. § 42-12007)*

**Class 7 (Historic):** (1%) Historic renovation value for property included in Class 1.

**Class 8 (Base):** (10%) Historic base value for property located in Class 4. *(A.R.S. § 42-12008)*

**Class 8 (Historic):** (1%) Historic renovation value for property located in Class 4.

**Class 9:** (1%) Possessory interests. *(A.R.S. § 42-12009)*

## ADMINISTRATION OF PROPOSAL

Adjustments to assessment ratios are not uncommon and appropriate agencies, including the Department of Revenue and county assessors, have had considerable experience through the years administering such changes. However, this proposal would require such agencies to administer this change for primary taxes only, maintaining the current assessment ratios for secondary (mostly voter-approved) taxes. There would be some administrative cost for the data processing changes necessary for the Department of Revenue, county assessors and county treasurers.

## IMPACT OF EXISTING REVENUE SYSTEMS

There are numerous impacts associated with this proposal and there are also assumptions that need to be made in order to estimate the impact on existing revenue systems. Although such a proposal would likely be phased in, for simplification purposes, the analysis was done on the full impact of the proposal. The key assumptions for the analysis regarded what changes would be made in the primary tax rates to adjust for the decline in net assessed value (NAV). The jurisdictions impacted by this proposal are the state, counties, community college districts, school districts, and cities and towns.

With the exception of the statutory tax rates set by the state, the assumption was made that local governments would recoup the loss in taxes by making commensurate adjustments to the primary tax rates. Although the counties, community college districts and cities and towns have constitutional primary levy limits, the formula would allow them to increase the tax rate to make up for the lost NAV.

The following state controlled primary tax rates were left at their current statutory levels: the qualifying tax rate (QTR) for K-12 school equalization (A.R.S. § 15-971); the county education equalization rate (A.R.S. § 15-994); the Minimum QTR for K-12 school districts (A.R.S. § 15-992); and the unorganized school district tax rate (A.R.S. § 15-991.01). However, the portion of the school district primary rates that are not controlled by the state (expenditures outside the budget limits) were adjusted upward to maintain the same levy.

Based on these assumptions, the impacts on state and local governments are twofold. First, at the local government level there is primarily a tax shift from class 1 to the other classes of property with little or no loss in tax revenue for the jurisdictions. Again, this scenario assumes the local governments will adjust the tax rates upward to keep levies constant. Second, there is both a loss in state general fund revenue as well as an increase in state expenditures to fund the school finance formula. *Note: With adjustments to the numerous statutorily set state rates, the negative impact on the state general fund could be eliminated. Adjustments to those rates would both decrease the tax reductions for class 1 as well as increase the tax shift to the other classes of properties.*

For comparative purposes, ***Table 1*** below shows the current statewide distribution of tax burdens by class for tax year 2002. While class 1 properties comprised 23.5% of the total full cash value,

those properties were responsible for 44.2% of the total taxes paid. The effective tax rate was 2.91%, compared to a 1.05% effective rate for owner-occupied homes.

***Table 1***

## 2002 statewide average effective property tax rates

| Class | Description | Assessment Ratio | Total Taxable Full Cash Value | Percent of Total FCV | Total Taxes Paid | Percent of Total Paid | Effective Rate |
|---|---|---|---|---|---|---|---|
| 1 | Commercial, industrial, utilities, & mines | 25% | $63,327,870,879 | 23.47% | $1,844,726,209 | 44.24% | 2.91% |
| 2 | Agricultural & vacant land | 16% | 19,731,879,936 | 7.31% | 317,242,001 | 7.61% | 1.61% |
| 3 | Owner-occupied residential | 10% | 158,164,295,799 | 58.62% | 1,658,758,696 | 39.78% | 1.05% |
| 4 | Rental Residential | 10% | 24,353,520,202 | 9.03% | 306,948,518 | 7.36% | 1.26% |
| 5 | Railroad, private car, airline flight | 20% | 1,096,016,250 | 0.41% | 26,554,841 | 0.64% | 2.42% |
| 6 | Residential historic, enterprise zones | 5% | 2,571,451,913 | 0.95% | 15,025,509 | 0.36% | 0.58% |
| 7 | Commercial historic | 1% | 20,497,803 | 0.01% | 445,152 | 0.01% | 2.17% |
| 8 | Rental residential historic | 1% | 563,360,325 | 0.21% | 109,584 | 0.00% | 0.02% |
| 9 | Possessory interests | 1% | 1,451,157 | 0.00% | 1,823 | 0.00% | 0.13% |
| Total | | | $269,830,344,264 | 100.00% | $4,169,812,332 | 100.00% | 1.55% |

Based on the previously discussed assumptions, ***Table*** 2 shows the effect of a change in assessment ratios for class 1 properties from 25% to 20% for tax year 2002. The effective tax rate on class 1 property drops from 2.91% to 2.60%, a 10.7% decrease in class 1 tax burdens on average. Fully implemented, the reduction in the class 1 ratio from 25% to 20% for primary taxes would reduce tax collections $200 million. While the effective tax rates of all of the other classes increase, those increases are less than the benefit provided to class 1. The effective tax rate on class 3 (owner-occupied homes) climbs 2.8%, from 1.05% to 1.08%.

The loss in NAV as a result of the proposed change has a significant impact on the state general fund. The overall impact is estimated at $133.8 million. The majority of the loss is the result of increased basic state aid payments to schools at $102 million, as well as another $15 million in state aid to offset levy reductions associated with the county equalization rate and properties not in school districts. As a result of increased taxes on class 3 (owner-occupied homes), the state also has increased costs associated with the 1% cap ($7.2 million) and the homeowner rebate ($5.5 million).

*Table 2*

# 2002 effective property tax rates based on 20% ratio for class 1 primary property taxes

| Class | Total Taxable Full Cash Value | Percent of Total | Total Yield | Percent of Total | Effective Rate | Difference In Yield |
|---|---|---|---|---|---|---|
| 1 | 63,327,870,879 | 23.47% | 1,645,190,273 | 40.74% | 2.60% | (200,003,696) |
| 2 | 19,731,879,936 | 7.31% | 326,242,935 | 8.08% | 1.65% | 8,906,296 |
| 3 | 158,164,295,799 | 58.62% | 1,705,920,036 | 42.24% | 1.08% | 45,994,860 |
| 4 | 24,353,520,202 | 9.03% | 317,242,679 | 7.86% | 1.30% | 10,189,732 |
| 5 | 1,096,016,250 | 0.41% | 27,552,250 | 0.68% | 2.51% | 994,798 |
| 6 | 2,571,451,913 | 0.95% | 15,553,511 | 0.39% | 0.60% | 527,920 |
| 7 | 20,497,803 | 0.01% | 466,912 | 0.01% | 2.28% | 21,760 |
| 8 | 563,360,325 | 0.21% | 114,282 | 0.00% | 0.02% | 4,698 |
| 9 | 1,451,157 | 0.00% | 1,908 | 0.00% | 0.13% | 85 |
| Total | 269,830,344,264 | 100.00% | 4,038,284,786 | 100.00% | 1.50% | (133,363,548) |

## COST TO ADMINISTER THE PROPOSAL

The proposal would not change current assessment procedures or processes. However, a separate category of assessed value would need to be calculated. Those assessed values would then be tracked separately. This is similar to changes made when assessment ratios on mine and utility properties were reduced from 30% to 25% over a five-year period starting in 1995, except that the ratios were adjusted for both primary and secondary taxes.

## POLICY CONSIDERATIONS

***Equity***

Arizona's current property tax system that applies varying assessment ratios to nine classifications of property in order to shift the distribution of the tax burden from one class to another fails most equity tests. As has been repeatedly documented, the system results in sizeable inequities in taxes between residential and business property. Arizona's commercial and industrial property taxes have been documented to be some of the highest in the country.

The following example using two hypothetical properties demonstrates the impact of the current assessment ratio for residential and business (assuming a rate of $1.00 per $100 of assessed value and that each property has a full cash value [FCV] of $500,000).

| | FCV | Assessment Ratio | Assessed value | Property Tax Rate | Tax |
|---|---|---|---|---|---|
| **business** | $500,000 | 25% | $125,000 | $1.00 | $1,250 |
| **home** | $500,000 | 10% | $50,000 | $1.00 | $500 |

If the ratio were adjusted to 20% for business property the above example would result in a $1,000 levy. The treatment of this hypothetical residential taxpayer would remain the same, again assuming a one-dollar tax rate.

| | FCV | Assessment Ratio | Assessed value | Property Tax Rate | Tax |
|---|---|---|---|---|---|
| **business** | $500,000 | 20% | $100,000 | $1.00 | $1,000 |
| **home** | $500,000 | 10% | $50,000 | $1.00 | $500 |

The use of multiple assessment ratios contributes significantly to Arizona's high ranking in comparative studies on property tax burdens. For example, while homeowner property ranked in the bottom half (31st), industrial property in Arizona ranks as high as 3rd nationally in a comparison of property tax burdens published by the *Minnesota Taxpayers Association* (see ***Attachment***).

Arizona's use of multiple assessment ratios also exacerbates inequities in the distribution of property wealth within school districts. Districts with large amounts of commercial or industrial property often have much higher assessed value per pupil than districts comprised primarily of residential property.

***Economic Vitality***
The practical effect of the high property tax burden is that few capital-intensive manufactures are willing to locate in Arizona without some form of tax break. Many of the recent manufacturing plants have been placed in foreign trade or enterprise zones (class 6) which are taxed at only 5% of value. While the equalizing effects of this proposal may take several years, it will eventually provide some reductions to the effective tax rates on business property, thereby improving Arizona's position for business location.

***Volatility***
See the discussion above on the impact on existing revenue systems.

***Simplicity***
Arizona has one of the most complicated property tax systems in the country. One of the features most responsible for that complexity is the classification system and its differential determinations of taxable values. The proposal would add a degree of complexity as a result of the differing assessment ratios for primary and secondary property tax purposes for class 1 property.

**ECONOMIC IMPACT**
This proposal would have a small impact on equalizing property tax burdens between business and residential classes of property. Although small, the change would also improve Arizona's position for business recruitment and retention by making an improvement in Arizona's high business property taxes.
These improvements would also have to be measured against possible tax increases the state might employ to make up for the lost revenue.

*Attachment*

# Residential vs. Industrial Property Taxes Rankings

(Payable 2000 – Largest Urban Areas)

## Residential Property Taxes

**$150,000 Land and Building**
**$50,000 Fixtures**

| Rank | State | Total Net Tax | Total ETR |
|---|---|---|---|
| 50 | Alabama | $ 887 | 0.444% |
| 19 | Alaska | 2,533 | 1.266% |
| **31** | **ARIZONA** | **1,741** | **0.871%** |
| 30 | Arkansas | 1,742 | 0.871% |
| 29 | California | 1,788 | 0.894% |
| 49 | Colorado | 977 | 0.489% |
| 15 | Connecticut | 2,989 | 1.495% |
| 32 | Delaware | 1,694 | 0.847% |
| 48 | District of Columbia | 1,005 | 0.503% |
| 10 | Florida | 3,278 | 1.639% |
| 42 | Georgia | 1,339 | 0.670% |
| 51 | Hawaii | 378 | 0.189% |
| 27 | Idaho | 1,866 | 0.933% |
| 1 | Illinois | 4,810 | 2.405% |
| 20 | Indiana | 2,515 | 1.258% |
| 14 | Iowa | 3,041 | 1.520% |
| 37 | Kansas | 1,531 | 0.765% |
| 22 | Kentucky | 2,197 | 1.099% |
| 43 | Louisiana | 1,246 | 0.623% |
| 9 | Maine | 3,432 | 1.716% |
| 12 | Maryland | 3,143 | 1.571% |
| 38 | Massachusetts | 1,473 | 0.737% |
| 2 | Michigan | 4,453 | 2.226% |
| 23 | Minnesota | 2,110 | 1.055% |
| 28 | Mississippi | 1,862 | 0.931% |
| 24 | Missouri | 2,055 | 1.028% |
| 41 | Montana | 1,386 | 0.693% |
| 17 | Nebraska | 2,688 | 1.344% |
| 35 | Nevada | 1,597 | 0.798% |
| 3 | New Hampshire | 4,116 | 2.058% |
| 5 | New Jersey | 4,047 | 2.024% |
| 40 | New Mexico | 1,399 | 0.700% |
| 44 | New York | 1,244 | 0.622% |
| 33 | North Carolina | 1,693 | 0.846% |
| 16 | North Dakota | 2,926 | 1.463% |
| 25 | Ohio | 2,054 | 1.027% |
| 36 | Oklahoma | 1,581 | 0.790% |
| 13 | Oregon | 3,051 | 1.526% |
| 6 | Pennsylvania | 3,927 | 1.964% |
| 8 | Rhode Island | 3,584 | 1.792% |
| 45 | South Carolina | 1,139 | 0.570% |
| 18 | South Dakota | 2,680 | 1.340% |
| 21 | Tennessee | 2,399 | 1.199% |
| 4 | Texas | 4,076 | 2.038% |
| 39 | Utah | 1,442 | 0.721% |
| 11 | Vermont | 3,199 | 1.600% |
| 26 | Virginia | 1,977 | 0.989% |
| 34 | Washington | 1,641 | 0.820% |
| 47 | West Virginia | 1,020 | 0.510% |
| 7 | Wisconsin | 3,812 | 1.906% |
| 46 | Wyoming | 1,062 | 0.531% |
| | **AVERAGE** | **$ 2,271** | **1.136%** |

## Industrial Property Taxes

**$25,000,000 Land and Building**
**$12,500,000 Machinery and Equipment**
**$10,000,000 Inventories $2,500,000 Fixtures**

| Rank | State | Total Net Tax | Total ETR |
|---|---|---|---|
| 42 | Alabama | $ 528,200 | 1.056% |
| 34 | Alaska | 674,813 | 1.350% |
| **3** | **ARIZONA** | **1,542,236** | **3.084%** |
| 38 | Arkansas | 602,753 | 1.206% |
| 45 | California | 500,000 | 1.000% |
| 27 | Colorado | 762,762 | 1.526% |
| 4 | Connecticut | 1,513,400 | 3.027% |
| 49 | Delaware | 434,732 | 0.869% |
| 19 | District of Columbia | 997,900 | 1.996% |
| 13 | Florida | 1,059,001 | 2.118% |
| 37 | Georgia | 619,995 | 1.240% |
| 51 | Hawaii | 224,468 | 0.449% |
| 32 | Idaho | 721,177 | 1.442% |
| 1 | Illinois | 1,967,725 | 3.935% |
| 5 | Indiana | 1,430,149 | 2.860% |
| 11 | Iowa | 1,128,649 | 2.257% |
| 8 | Kansas | 1,182,137 | 2.364% |
| 30 | Kentucky | 728,510 | 1.457% |
| 9 | Louisiana | 1,165,072 | 2.330% |
| 20 | Maine | 960,000 | 1.920% |
| 31 | Maryland | 721,680 | 1.443% |
| 25 | Massachusetts | 855,250 | 1.711% |
| 2 | Michigan | 1,547,358 | 3.095% |
| 10 | Minnesota | 1,142,434 | 2.285% |
| 23 | Mississippi | 892,042 | 1.784% |
| 12 | Missouri | 1,062,787 | 2.126% |
| 43 | Montana | 506,873 | 1.014% |
| 28 | Nebraska | 733,906 | 1.468% |
| 48 | Nevada | 435,606 | 0.871% |
| 33 | New Hampshire | 686,025 | 1.372% |
| 18 | New Jersey | 1,016,155 | 2.032% |
| 44 | New Mexico | 500,407 | 1.001% |
| 15 | New York | 1,025,703 | 2.051% |
| 46 | North Carolina | 461,653 | 0.923% |
| 41 | North Dakota | 549,371 | 1.099% |
| 24 | Ohio | 887,638 | 1.775% |
| 36 | Oklahoma | 650,123 | 1.300% |
| 26 | Oregon | 813,600 | 1.627% |
| 16 | Pennsylvania | 1,020,413 | 2.041% |
| 7 | Rhode Island | 1,213,301 | 2.427% |
| 14 | South Carolina | 1,042,192 | 2.084% |
| 35 | South Dakota | 651,015 | 1.302% |
| 21 | Tennessee | 950,609 | 1.901% |
| 6 | Texas | 1,417,550 | 2.835% |
| 39 | Utah | 569,959 | 1.140% |
| 17 | Vermont | 1,018,642 | 2.037% |
| 40 | Virginia | 554,704 | 1.109% |
| 47 | Washington | 454,558 | 0.909% |
| 22 | West Virginia | 901,388 | 1.803% |
| 29 | Wisconsin | 733,030 | 1.466% |
| 50 | Wyoming | 342,700 | 0.685% |
| | **AVERAGE** | **$ 864,752** | **1.730%** |

***Source: Minnesota Taxpayers Association***